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Big Bank Boards: The Case for Heightened Administrative Enforcement

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BIG BANK BOARDS: THE CASE FOR HEIGHTENED ADMINISTRATIVE ENFORCEMENT

*Heidi Mandanis Schooner**

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INTRODUCTION

From 2011 to 2012, JPMorgan Chase & Co. (JPMorgan) converted its hedging operations into a high-risk, large-volume trading operation that nose-dived into more than \$6.2 billion in losses.¹ The London Whale debacle is a cautionary tale that is alarming not only given the large losses but also because it implicated the risk management operations of the United States' largest bank holding company at a time, just a few years following the worst financial crisis since the Great Depression, when one would expect the finest diligence by both bank management and bank regulators.

Scrutiny of financial institutions and their regulators remains high even while the Financial Crisis of 2007–2009 begins to feel like history. Scandals involving large financial institutions, like London Whale, continue to make headline news. Wells Fargo's account opening scandal is a very recent example. In the fall of 2016, Wells Fargo announced that it paid over \$185 million in fines to the City of Los Angeles and to federal regulators to settle claims related to the bank opening millions of fake bank accounts in order to generate fee income.² The repercussions of the scandal continue³ with congressional hearings,⁴ the resignation of John Stumpf, former Wells Fargo CEO, further federal investigations,⁵ and mounting litigation.⁶

Scrutiny of bank management is not only appropriate because banks sometimes, like in the case of Wells Fargo's account scandal, cheat their

1. For a full exploration, see PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, U.S. SENATE, 113TH CONG., JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES (2013), <http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-2013> [hereinafter Senate Report].

2. See Press Release, Wells Fargo, Wells Fargo Issues Statement on Agreements Related to Sales Practices (Sept. 8, 2016), https://www.wellsfargo.com/about/press/2016/sales-practices-agreements_0908.content.

3. Even Saturday Night Live hopped on the Wells Fargo bandwagon featuring a skit with Lin-Manuel Miranda as the conniving Wells Fargo man. See *Saturday Night Live: Wells Fargo Wagon*, (NBC television broadcast Oct. 8, 2016), <http://www.nbc.com/saturday-night-live/video/wells-fargo-wagon/3112633?snl=1>.

4. The House Financial Services Committee held hearings on September 29, 2016. See Memorandum from the FSC Majority Committee Staff to the Members of the Committee on Financial Services (Sept. 26, 2016), http://financialservices.house.gov/uploadedfiles/092916_fc_memo.pdf (setting date for hearing on "Holding Wall Street Accountable"). The Senate Banking Committee held hearings on September 20, 2016. *An Examination of Wells Fargo's Unauthorized Accounts and the Regulatory Response*, U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFF. (Sept. 20, 2016, 10:00 AM), <http://www.banking.senate.gov/public/index.cfm/hearings?ID=B80F9B81-4331-4F95-91BC-718288EC9DA0>.

5. See Emily Glazer & Christopher M. Matthews, *Federal Prosecutors Investigating Wells Fargo Over Sales Tactics*, WALL ST. J. (Sept. 14, 2016), <https://www.wsj.com/articles/federal-prosecutors-investigating-wells-fargo-over-sales-tactics-1473881424>.

6. See James Rufus Koren, *Wells Fargo Hit with Multiple Lawsuits Involving Bogus Accounts, Aggressive Sales Quotas*, L.A. TIMES (Sept. 26, 2016, 5:40 AM), <http://www.latimes.com/business/la-fi-wells-class-action-20160926-snap-story.html>.

customers, or, like in the case of London Whale, lose lots of money by taking outsized risks. Poor bank management can have broader implications because of spillover effects that can disrupt segments of the economy (in the case of smaller banks)⁷ and the entire economy (in the case of large banks).⁸ For this reason, all banks are subject to extensive regulation, enjoy the benefits of deposit insurance, and are granted access to the Federal Reserve as lender of last resort. The Financial Crisis illustrated the fact that the financial distress of a non-bank can also be disruptive. Therefore, when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),⁹ it gave the Federal Reserve new authority to regulate certain non-bank financial institutions designated by the Financial Stability Oversight Council (FSOC).¹⁰ At the same time, Congress recognized that large bank holding companies can cause greater disruption to the economy than smaller ones and, consequently, should be subjected to a more rigorous prudential regime than smaller banks. Thus, Dodd-Frank directs the Federal Reserve to subject large bank holding companies with assets of \$50 billion or more and non-bank financial institutions designated by FSOC to greater supervision than that applied to smaller bank holding companies.¹¹ This Article directs attention to the enforcement implications of the heightened system of supervision on liability of banks' directors—in particular, the liability created through statutory administrative enforcement.

This Article first considers the possible liability of the JPMorgan board in the London Whale matter. This discussion is not meant to assign liability in that case. Rather, the London Whale episode is considered as a springboard to a broader discussion of big bank officer and director liability. While it may be tempting to shrug off the regulatory implications of the London Whale episode because the losses did not threaten the solvency of JPMorgan, the significance of such management failures should not be ignored. Effective management of large banks is essential to financial stability. The type of poor management potentially at play in the London Whale matter could implicate the effectiveness of management in areas that have significant financial stability implications. For example, while London Whale suggests lax management in the bank's trading

7. For a discussion of the impact of community bank failure on regional and local economies, see Heidi Mandanis Schooner, *Regulating Angels*, 50 GA. L. REV. 143, 145–46, 150–52 (2015).

8. For a discussion of the economic consequences of the Financial Crisis, see FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 215, 389–410 (2011), <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

9. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

10. See 12 U.S.C. § 5323(a) (2012).

11. See *id.* § 5365(a).

operations, this could be a red flag regarding management deficiencies in other areas of operations such as cybersecurity or data management.¹² Since effective bank management is essential to financial stability, consideration of incentives for effective management, like the personal liability of officers and directors, remains an important issue.

Following the discussion of the litigation in the London Whale case, this Article moves on to consider the existing administrative enforcement powers of the banking agencies and how these powers might be applied in a case of risk management failure. This Article uses the London Whale experience to explore the statutory opportunities as well as challenges faced by the banking agencies in utilizing their administrative enforcement powers.

Finally, this Article considers bank director liability in the context of the enhanced supervisory regime put in place following the Financial Crisis. Traditional mechanisms for monitoring management behavior, in the form of shareholder derivative claims of breach of fiduciary duty, are not well suited to the task of monitoring bank managers' effectiveness in limiting the externalities that lead to financial instability. While the purpose of agency enforcement powers is squarely prudential (i.e., meant to ensure the safe and sound operation of financial institutions), current administrative enforcement powers do not appropriately supplement and support Congress's vision of enhanced supervision of large banks. In particular, the fact that negligent or grossly negligent behavior does not trigger the agencies' removal or prohibition power undermines the goals of enhanced supervision of large banks.

I. LONDON WHALE RISK MANAGEMENT FAILURE

Consider the officers and directors of JPMorgan Chase circa 2012. These are the managers whose responsibilities included oversight of an outsized high-risk trading¹³ operation run by JPMorgan's Chief Investment Office (CIO) that resulted in a \$6.2 billion loss to the bank. A Senate Subcommittee report on the London Whale matter included alarming findings regarding the bank's risk management practices.¹⁴ Among other

12. Cybersecurity and data deficiencies are two of seven key threats to financial stability identified by the Office of Financial Research. OFFICE OF FIN. RESEARCH, DEP'T OF THE TREASURY, 2016 FINANCIAL STABILITY REPORT 2 (2016), https://www.financialresearch.gov/financial-stability-reports/files/OFR_2016_Financial-Stability-Report.pdf. The other five threats identified are: potential spillovers from Europe; risks in U.S. nonfinancial corporate credit; central counterparties as contagion channels; pressure on U.S. life insurance companies; and systemic footprints of largest U.S. banks. *Id.*

13. For a discussion of whether the trades were for speculative or hedging purposes, see CLAIRE A. HILL & RICHARD W. PAINTER, BETTER BANKERS, BETTER BANKS: PROMOTING GOOD BUSINESS THROUGH CONTRACTUAL COMMITMENT 44–46 (2015).

14. See Senate Report, *supra* note 1, at 153–214.

findings, the Senate Report explains that JPMorgan's risk management systems included a number of risk limits (e.g., a limit tied to VaR models¹⁵). These limits were set by bank executives and regularly discussed by the Board of Director's Risk Policy Committee. Breaches of risk limits were meant to trigger remedial action but, in practice, served more like an early warning system. However it was supposed to operate, the system of risk limits failed. According to the Senate Report: "Over the course of 2011 and 2012, the SCP [synthetic credit portfolio] breached every risk limit that the Subcommittee examined, but none of those breaches led to an analysis of whether the portfolio was engaged in overly risky trading activities."¹⁶ The Senate Report also describes non-public supervisory notices sent by the Office of the Comptroller of the Currency (OCC) to JPMorgan in which the OCC makes the following assessment of the risk management failures: "Management oversight of CIO was inadequate. Business management was allowed to operate with little effective challenge from either the board or executive management."¹⁷ It should be noted that the Senate Report is also critical of the OCC which, despite having sixty-five examiners on site at JP Morgan, "failed to notice or investigate bank reports of CIO risk limit breaches, failed to realize when monthly CIO reports weren't delivered, failed to insist on detailed trading data from the CIO needed for effective oversight, and failed to take firm action when the bank delayed or denied its requests for information."¹⁸

Given the alarming losses and reports of management failure, it comes as no surprise that the whale trades generated significant litigation.¹⁹ An investor class action brought against JPMorgan, Jamie Dimon (CEO), and Doug Braunstein (CFO) alleging misleading statements and losses in connection with the whale trades settled for \$150 million.²⁰ Shareholder derivative suits were filed against the board in both Delaware and New York but were dismissed on procedural grounds.²¹ Criminal charges were brought against two former JPMorgan traders;²² however, no such charges

15. Very generally, value at risk (VaR) measures the risk of investments.

16. Senate Report, *supra* note 1, at 159.

17. *Id.* at 212 (quoting OCC Supervisory Letter to JPMorgan Chase on Examination of VaR Model Risk Management PSI-OCC-17-000015 (Nov. 6, 2012)) (internal quotation marks omitted).

18. *Id.* at 250.

19. It is beyond the scope of this Article to conclude that the litigation was or was not successful.

20. See John Kennedy, *\$150M 'London Whale' Settlement Gets Judge's OK*, LAW360 (May 10, 2016, 3:29 PM), <https://www.law360.com/articles/794169/150m-london-whale-settlement-gets-judge-s-ok>.

21. See Stephanie Russell-Kraft, *Del. Chancery Judge Tosses 'London Whale' Derivative Suit*, LAW360 (May 22, 2015, 5:41 PM), <https://www.law360.com/articles/659384/del-chancery-judge-tosses-london-whale-derivative-suit>.

22. Press Release, U.S. Dep't of Justice, Justice Department Announces Charges Filed Against Two Derivatives Traders in Connection with Multi-Billion Dollar Trading Loss at JPMorgan Chase &

have been brought against executive officers or members of the board. The Federal Reserve,²³ OCC,²⁴ Securities and Exchange Commission,²⁵ and the Commodity Futures Trading Commission²⁶ all extracted civil money penalties from the bank itself; none have brought any action against the board.

Corporate governance scholars would see the London Whale case as an ideal vehicle for exploring the nature of directors' duties of oversight and good faith²⁷ as developed by the Delaware courts—often referred to as *Caremark* duties.²⁸ Such claims require a showing of intentional failure to act in the face of a known duty to act.²⁹ A plaintiff can show lack of good faith in oversight duties by “properly alleging particularized facts that show that a director consciously disregarded an obligation to be reasonably informed about the business and its risks or consciously disregarded the duty to monitor and oversee the business.”³⁰ Shareholders initiated derivative suits against JPMorgan's board claiming, inter alia, bad faith/lack of proper oversight. Plaintiffs in these derivative suits argued that the members of the board violated their oversight duties by failing to implement a risk management system that was commensurate with the risks associated with the high-volume, speculative trades executed by

Company (Aug. 14, 2013), <https://www.justice.gov/opa/pr/justice-department-announces-charges-filed-against-two-derivatives-traders-connection-multi>.

23. Order of Assessment of a Civil Money Penalty Issued Upon Consent at 5, JPMorgan Chase & Co., No. 13-031-CMP-HC (Bd. of Governors of the Fed. Reserve Sys. Sept. 18, 2013), <http://perma.cc/Y2AC-Q8R7> (\$200 million civil money penalty imposed on the bank holding company).

24. Consent Order for a Civil Money Penalty at 4, JPMorgan Chase Bank, No. AA-EC-2013-75 (Dep't of Treasury Comptroller of Currency Sept. 18, 2013), <http://perma.cc/PX73-TW38> (\$300 million civil money penalty imposed on the bank).

25. Order Instituting Cease-and-Desist Proceedings at 19, JP Morgan Chase & Co., Exchange Act Release No. 70458, (Sec. & Exch. Comm'n Sept. 19, 2013), 2013 WL 5275772 (\$200 million civil money penalty imposed on the bank holding company).

26. Order Instituting Proceedings at 17, JPMorgan Chase Bank, CFTC No. 14-01 (Commodity Futures Trading Commission Oct. 16, 2013), 2013 WL 6057042 (\$100 million civil money penalty imposed on the bank).

27. These duties are viewed as part of a director's duty of loyalty. While the duty of care would be equally implicated in such circumstances because of the potential failure of the board to adequately inform itself, duty of care claims are often eliminated from consideration in suits for damages because Delaware law allows such claims to be exculpated in the corporate charter. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011). This is significant because the lack of good faith, duty of loyalty type of claim requires a showing of greater culpability than a duty of care claim. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 66 (Del. 2006).

28. Chancellor Allen's opinion in *In re Caremark International Inc. Derivative Litigation* began the Delaware court's exploration of the nature of the board's oversight duties. 698 A.2d 959 (Del. Ch. 1996).

29. *See Walt Disney Co. Derivative Litig.*, 906 A.2d at 67.

30. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009) (emphasis omitted). Significantly, the pleading standards under Delaware law require allegation of particularized facts. DEL. CHAN. R. 23.1.

JPMorgan's CIO.³¹ Plaintiffs asserted that the board knew or consciously disregarded the fast-growing risk in the CIO.³²

In a suit filed in the Southern District of New York, the court noted that the plaintiffs were pursuing a particularly difficult type of oversight claim because the nature of the claim was a failure to oversee business risk,³³ as opposed to, for example, the failure to oversee potential illegal activity. The court explained that the plaintiffs would have to allege that the board “consciously disregarded red flags signaling that the company’s employees were taking facially improper . . . business risks.”³⁴ This high standard of liability led to the dismissal of the case on procedural grounds.³⁵ Substantially similar derivative suits brought in New York and Delaware courts were also dismissed at the pleading stage.³⁶

Observers of the London Whale derivative claims might be critical of rulings that terminated the plaintiffs’ claims at the pleading stage. Many of those potential objections relate to the longstanding obstacles to bringing derivative claims and are well beyond the scope of this Article. More particularly relevant to this discussion are the challenges in utilizing fiduciary duty principles to address the considerable negative externalities generated from the operations of very large financial institutions. Since the Financial Crisis, scholars have explored whether shareholder actions asserting breach of fiduciary duty can serve to address such externalities. Many scholars have concluded that the traditional model, in which directors’ duties are measured against the pursuit of maximum shareholder value (as measured by stock price), is ill-suited as a measure of proper management of a large financial institution whose operations can have significant negative spillover effects throughout the economy.³⁷ The

31. *In re JPMorgan Chase & Co. Derivative Litig.*, No. 12 Civ. 03878(GBD), 2014 WL 1297824, at *1 (S.D.N.Y. Mar. 31, 2014).

32. *Id.* at *1–*2.

33. *Id.* at *4.

34. *Id.* at *1 (quoting *In re Goldman Sachs Grp., Inc. S’holder Litig.*, No. 5215-VCG, 2011 WL 4826104, at *22 n.217 (Del. Ch. Oct. 12, 2011)).

35. *Id.* at *7. The plaintiff was unable to allege with particularized facts, at the pleading stage, that a majority of the board ignored red flags. This meant that the plaintiffs in this derivative action were unable to establish that their demand on the board to bring this action was futile and, therefore, excused. Reconsideration of the case was denied. *In re JPMorgan Chase & Co. Derivative Litig.*, No. 12 Civ. 03878(GBD), 2014 WL 3778181 (S.D.N.Y. July 30, 2014).

36. *Asbestos Workers 42 Pension Fund v. Bammann*, No. 9772–VCG, 2015 WL 2455469, at *20 (Del. Ch. May 22, 2015), *aff’d* 132 A.3d 749 (Del. 2016) (Delaware Chancery Court granted the defendant’s motion to dismiss, holding that the plaintiff was collaterally estopped from relitigating issues already decided in the New York litigation); *Wandel v. Dimon*, 135 A.D.3d 515, 518 (N.Y. App. Div. 2016) (granting defendant’s motion to dismiss based on plaintiffs’ failure to establish demand futility).

37. See John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35 (2014); Jill E. Fisch, *The Mess at Morgan: Risk, Incentives and Shareholder Empowerment*, 83 U. CIN. L. REV. 651 (2015); Hwa-Jin Kim, *Financial Regulation and Supervision in*

discussion that follows begins with the same premise, i.e., that managing large financial institutions is different because of the significant externalities, but takes that premise one step further by suggesting that reimagining the fiduciary duties owed to the corporation is only an indirect solution to the externalities associated with poor management. Instead, the following redirects the discussion by examining external administrative enforcement proceedings as a potential source of board monitoring as opposed to internal corporate governance claims.

II. BANK REGULATORS' ADMINISTRATIVE ENFORCEMENT POWERS

The inability to bring the London Whale derivative claims beyond the pleading stage raises the question of whether the banking agencies (as opposed to the bank's shareholders) sought any form of sanction against the members of the board. As discussed above, federal agencies imposed civil money penalties on JPMorgan, but no administrative enforcement actions emerged against bank officers or directors. It is tempting to chalk this up to administrative forbearance that stems from some form of regulatory capture. And yet, other explanations are perhaps just as likely. To enable such evaluation, this Part begins with an overview of the federal banking agencies' administrative enforcement powers and concludes with an examination of the actual as well as potential application of such powers to the London Whale episode.

A. *Overview of Agency Enforcement Powers*

Perhaps the most high-profile cases brought against bank officers and directors by federal regulators are the professional liability claims brought by the FDIC as receiver of a failed bank.³⁸ When a bank fails, the FDIC steps into the shoes of the failed bank,³⁹ which empowers the FDIC to sue the board of directors for breach of their fiduciary duties. Since the FDIC sues on behalf of the bank itself, the procedural demand requirements of the typical shareholder derivative suit do not apply. Unlike the administrative enforcement powers discussed in the remainder of this Part, the FDIC's receivership cases are filed civilly, utilizing statutory authority granted to the FDIC to bring such claims for monetary damages, imposing liability on directors for gross negligence, and preserving state law claims

Corporate Governance of Banks, 41 J. CORP. L. 707 (2016); Steven L. Schwarcz, *Misalignment: Corporate Risk-Taking and Public Duty*, 92 NOTRE DAME L. REV. 1 (2016).

38. 12 U.S.C. § 1821(c) (2012).

39. *See id.* § 1821(d)(2).

with a lower standard of proof, e.g., breach of ordinary care.⁴⁰ Since 2009, the FDIC, as receiver, has authorized suits against 1,216 individual officers or directors of failed banks.⁴¹

While the FDIC's suits against directors of failed banks are the most notorious, such cases have limited importance in the context of the directors of a large financial institution since such institutions rarely fail.⁴² Title II of Dodd Frank expands the FDIC's receivership powers beyond insured depository institutions and grants the FDIC with potential⁴³ receivership powers⁴⁴ over bank holding companies and non-bank financial companies supervised by the Federal Reserve. Such authority, however, remains untested. Therefore, consideration of the administrative liability of directors of operating institutions is important because, again, big banks do not typically fail and, as seen in the context of the London Whale episode, private civil suits against directors may not be successful in monitoring board behavior.

Directors of both failed and operating banks are brought within the administrative enforcement powers of the banking agencies⁴⁵ as "institution-affiliated part[ies]" (IAP), which include directors and officers of insured depository institutions.⁴⁶ Three types of administrative enforcement proceedings, discussed below, are most relevant to bank management: cease-and-desist proceedings, civil money penalties, and orders of suspension or prohibition.⁴⁷

40. See *id.* § 1821(k). The statute's savings clause provides: "Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law." *Id.* Discussion of the case law determining the meaning of that clause is beyond the scope of this discussion.

41. See *Professional Liability Lawsuits*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/bank/individual/failed/pls/> (last updated Feb. 24, 2017).

42. The failure of Washington Mutual (WaMu), with combined assets of \$307 billion and total deposits of \$188 billion, is the largest bank failure in U.S. history. See Robin Sidel et al., *WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, WALL ST. J. (Sept. 26, 2008, 12:01 AM), <https://www.wsj.com/articles/SB122238415586576687>. In 2011, the FDIC, as receiver, brought suit against former officers and directors of WaMu, claiming negligence, gross negligence, and breach of fiduciary duty. *FDIC v. Killinger*, No. C11-459 MJP, 2011 WL 4440410 (W.D. Wash. Sept. 21, 2011). The case was settled.

43. The authority of the FDIC in such circumstances depends on a systemic risk determination as provided under Title II of Dodd Frank. 12 U.S.C. § 5383 (2012).

44. *Id.* § 5390(a).

45. The federal banking statutes use the term "appropriate Federal banking agency" (AFBA) to identify which federal banking agency has the authority to bring an administrative enforcement action, among other things. *Id.* § 1813(q). The AFBA for a national bank is the OCC; for a state member insured bank and any bank holding company, it is the Federal Reserve; for a state nonmember insured banks, it is the FDIC. *Id.*

46. *Id.* § 1813(u)(1).

47. Note that the Federal Reserve may utilize all of the enforcement powers discussed above in supervising bank holding companies, *id.* § 1818(b)(3), and designated nonbank financial companies, *id.* § 5362(a) ("[A] nonbank financial company supervised by the Board of Governors and any subsidiaries of such company (other than any depository institution subsidiary) shall be subject to the provisions of

The banking agencies have the authority to issue a cease-and-desist order against a bank director if the director is engaging, has engaged, or is about to engage in an unsafe or unsound banking practice, or has violated a law, rule, regulation, or condition imposed in writing by the agency.⁴⁸ The cease-and-desist power includes the authority to require directors to make restitution or provide reimbursement, indemnification, or guarantee against loss, but only if the director was unjustly enriched or acted in reckless disregard of the law.⁴⁹

The agencies' enforcement powers include the authority to remove or suspend a bank director from office or prohibit the director from participating in the affairs of the bank if the agency determines that: (1) the director has, *inter alia*, violated a law or regulation, engaged in an unsafe or unsound banking practice, or breached their fiduciary duty; (2) by reason of such violation, practice, or breach, the bank suffered or will probably suffer financial loss or other damage, or the interests of the bank's depositors have been or could be prejudiced, or the director has received financial gain or other benefit; and (3) the violation, practice, or breach involved personal dishonesty or demonstrated willful or continuing disregard by the director for the safety or soundness of the bank.⁵⁰

Bank directors also face potential liability for three tiers of civil money penalties (First Tier penalty of up to \$5,000 for each day the violation continues; Second Tier up to \$25,000 per day; and Third Tier up to \$1,000,000 per day).⁵¹ First Tier penalties are available for any violation of law or regulation.⁵² First Tier violations are significant because they are strict liability violations—requiring no proof of culpability, unlike higher tier violations. Second Tier penalties require an agency determination of (1) a First Tier violation or recklessly engaging in an unsafe or unsound practice or breach of fiduciary duty, and (2) that such violation, practice, or breach is part of (a) a pattern of misconduct, (b) causes or is likely to cause more than minimal loss to the bank, or (c) results in pecuniary gain or other benefit to the director.⁵³ Third Tier penalties are available if the agency determines that a director (1) knowingly violated a law or regulation or

subsections (b) through (n) of section 1818 of this title, in the same manner and to the same extent as if the company were a bank holding company, as provided in section 1818(b)(3) of this title.”).

48. *Id.* § 1818(b)(1).

49. *Id.* § 1818(b)(6).

50. *Id.* § 1818(e)(1). The statute provides for notice and hearing before removal. *Id.* § 1818(e)(4). A director who is subject to a removal or prohibition order is also prohibited from participating in the conduct of the affairs of any insured depository institution unless the director received written consent from the agencies. *Id.* § 1818(e)(7)(A)–(B).

51. *Id.* § 1818(i)(2).

52. *Id.* § 1818(i)(2)(A). First Tier penalties are also available based on a violation of any agency order, written agreement or condition. *Id.*

53. *Id.* § 1818(i)(2)(B).

engaged in unsafe or unsound practices or breached fiduciary duty and (2) either knowingly or recklessly caused a substantial loss to the bank or received a substantial pecuniary gain or other benefit by reason of such practice.⁵⁴

Because the term is specific to banking statutes, a brief overview of the meaning of “unsafe or unsound [banking] practices” is appropriate. The meaning of unsafe or unsound banking practices has been the subject of some debate because Congress never provided a comprehensive definition. Courts have often cited legislative history describing the term as follows:

Like many other generic terms widely used in the law, such as “fraud,” “negligence,” “probable cause,” or “good faith,” the term “unsafe or unsound practices” has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an “unsafe or unsound practice” embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.⁵⁵

Yet, courts’ interpretation of the phrase is not limited to this legislative history. The Fifth Circuit, for example, has linked the concept of unsafe or unsound banking practices more directly to the institution’s solvency, holding that such practices are limited to those “with a reasonably direct effect on [a bank’s] financial soundness.”⁵⁶

The banking agencies often utilize the administrative enforcement powers discussed above. A 2014 study by the Offices of Inspector General of the federal banking agencies (OIG Report) analyzed the 275 administrative enforcement actions brought against institution-affiliated parties of failed banks from September 2008 to September 2013.⁵⁷ The most commonly used administrative sanction was removal/prohibition (128), then civil money penalties (120), personal cease-and-desist orders

54. *Id.* § 1818(i)(2)(C).

55. *Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the H. Comm. on Banking and Currency*, 89th Cong. 50 (1966) (memorandum submitted by John Horne, Chairman of the Federal Home Loan Bank Board).

56. *Gulf Fed. Sav. & Loan Ass’n v. Fed. Home Loan Bank Bd.*, 651 F.2d 259, 264 (5th Cir. 1981). For a full discussion of courts’ interpretations of unsafe or unsound banking practices, see Heidi Mandanis Schooner, *Fiduciary Duties’ Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 190–95 (1995).

57. OFFICES OF INSPECTOR GEN., EVAL-14-002, ENFORCEMENT ACTIONS AND PROFESSIONAL LIABILITY CLAIMS AGAINST INSTITUTION-AFFILIATED PARTIES AND INDIVIDUALS ASSOCIATED WITH FAILED INSTITUTIONS 4 (2014).

(19), and, finally, administrative restitution (8).⁵⁸ The OIG Report noted challenges the agencies face in bringing certain actions. With regard to the use of removal/prohibition authority, regulators noted the inability to bring such actions in the case of poor or negligent conduct.⁵⁹ The statute requires, as discussed above, a higher degree of culpability. The OIG Report also notes that the Fifth Circuit's interpretation of "unsafe and unsound [banking] practices" limits the scope of administrative enforcement actions because such interpretation does not include practices that threaten significant loss but do not threaten the viability of the bank.⁶⁰ With regard to these limitations, the OIG Report states that "[t]he Regulators noted that because removal/prohibition orders permanently remove IAPs from banking, thus, taking away their livelihood, it is appropriate for the legal standards to be rigorous."⁶¹ The OIG Report encouraged regulators to consider greater use of cease-and-desist orders since the statutory requirements for such actions are less rigorous.⁶² Finally, the OIG Report identified a number of other factors limiting actions against IAPs, including, among other things: the agencies' reluctance to bring cases with limited chance of success to avoid negative precedent, actions barred by the statute of limitations, limited staff resources, and limited resources of the respondent to pay civil money penalties or restitution.⁶³

B. London Whale Administrative Enforcement Actions

JPMorgan paid civil money penalties in connection with the London Whale trades in administrative enforcement actions brought by the four federal financial regulators.⁶⁴ No enforcement actions were brought against individual bank officers or directors. Perhaps the simplest explanation for the lack of administrative enforcement actions against the officers and directors is that the banking agencies did not find any of them culpable—not even negligent. Yet, the Federal Reserve's civil money penalty order notes deficiencies in the bank's risk management functions including the failure of "senior management's elevation of issues to the board of directors, which did not allow for the board of directors' meaningful consideration of such issues."⁶⁵ This finding appears to implicate "senior

58. *Id.* at 13.

59. *Id.* at 20.

60. *Id.* at 21.

61. *Id.* at 22.

62. *Id.* at 23.

63. *Id.* at 24–25.

64. *See supra* notes 23–26 and accompanying text.

65. Order of Assessment of a Civil Money Penalty, *supra* note 23, at 2. Of course, this observation does not explain the lack of enforcement action against "senior management."

management” (for their failure to “elevate”) but perhaps exculpate members of the board of directors (who possibly saw no red flags). Of course, in this sort of analysis, it is appropriate to distinguish between inside and outside board members, i.e., those board members who are officers versus those who are not. In other words, a full analysis would require consideration of whether any of those “senior managers” were also members of the board. More generally and hypothetically, what if bank officers and/or directors were negligent or grossly negligent in overseeing the bank’s risk management system? Can the lack of enforcement against the officers and directors be explained even under such a scenario?

With regard to pursuing possible breach of fiduciary duty claims, the FDIC, as discussed above, has the most experience bringing such cases, but only as a receiver for a failed bank. With regard to operating institutions, breach of fiduciary duty can implicate removal/prohibition if, as potentially applicable here, the bank suffers financial loss by reason of the breach. Furthermore, such enforcement actions would not be subject to the rigorous pleading standards faced in the derivative actions brought by shareholders of JPMorgan.⁶⁶ But, in such removal/prohibition cases, the breach of fiduciary duty must also involve “personal dishonesty” or “willful or continuing disregard” for the bank’s safety and soundness.⁶⁷ These obstacles are significant and may, therefore, explain the absence of a removal/prohibition order against JPMorgan officers and directors.

As discussed, federal agencies imposed civil money penalties on JPMorgan—both the holding company and the bank. For example, the OCC’s civil money penalty order found, among other things, the following unsafe or unsound banking practices: deficiencies in the bank’s oversight and governance of trading by the CIO and deficiencies in risk management for the credit derivatives trading by the CIO.⁶⁸ Given that these findings point to JPMorgan’s management function, manager effectiveness seems implicated. Most relevant to the London Whale type of scenario, a Second Tier civil money penalty can be imposed on officers and directors for

66. See *supra* notes 21, 31–36 and accompanying text (discussing the shareholder litigation in the London Whale matter). Also, *Caremark*-type oversight cases require a showing of “conscious disregard”—a standard that is difficult to prove. See *supra* notes 28–30 and accompanying text. It seems, however, that an administrative enforcement case based on breach of fiduciary duty would not be restricted by the statutory exculpation of duty of care claims since an action to remove a director would not be “personal liability of a director to the corporation or its stockholders for monetary damages.” DEL. CODE ANN. Tit. 8, § 102(b)(7) (2011). A duty of care claim can be based on the failure of the board to adequately inform itself, which can be easier to prove than a duty of loyalty/failure of oversight claim. See *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. 1985), *superseded by statute*, DEL. CODE ANN. Tit. 8, § 102(b)(7) (2011), *as recognized in* *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001).

67. See *supra* note 50 and accompanying text.

68. See Consent Order for a Civil Money Penalty, *supra* note 24, at 3–4, 9–13 (\$300 million civil money penalty imposed on the bank).

breach of any fiduciary duty which causes more than a minimal loss.⁶⁹ While three civil suits brought against the JPMorgan board were dismissed, recall that the dismissal was based on the plaintiff's failure to meet the procedural demand requirements in shareholder derivative proceedings.⁷⁰ The dismissal of such suits does not mean that the board, or particular members of the board, did not breach their fiduciary duties. And, such breach could serve as a basis for a civil money penalty since the loss to the bank was more than minimal.

The agencies' cease-and-desist power offers the most flexibility. An IAP could be subjected to a cease-and-desist order for, among other things, engaging in an unsafe or unsound banking practice. Unsafe or unsound banking practices are negligence-based since such practices constitute a deviation from generally accepted practices of prudent operation.⁷¹ The twist in the context of the London Whale matter is that while the losses were great, such losses never threatened the viability of JPMorgan. Under the Fifth Circuit's interpretation of unsafe or unsound, the deficient practices that cause losses that do not threaten solvency may not meet the standard.⁷²

For these reasons, the lack of agency action against officers and directors can be explained, perhaps, based on the required determinations of the relevant statutes. This means that even if JPMorgan's officers and directors had been negligent or grossly negligent in their oversight of the company's risk management systems, significant obstacles might prevent agency enforcement action against those individuals.

III. THE CASE FOR ENHANCED ADMINISTRATIVE ENFORCEMENT POWERS

In response to the Financial Crisis, Congress developed an enhanced supervisory regime "to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions,"⁷³ Dodd-Frank directs the Federal Reserve to subject large bank holding companies with \$50 billion or more in assets to "more

69. 12 U.S.C. § 1818(i)(2)(B) (2012).

70. See *supra* notes 20–21, 31–36 and accompanying text (discussing the shareholder derivative suits brought against the JPMorgan board).

71. For further discussion, see Schooner, *supra* note 56, at 187–201.

72. *Gulf Fed. Sav. & Loan Ass'n v. Fed. Home Loan Bank Bd.*, 651 F.2d 259, 264 (5th Cir. 1981). It is important to note that the facts giving rise to the Fifth Circuit's decision in *Gulf Federal* pale in comparison to the circumstances of London Whale. In *Gulf Federal*, the bank miscalculated interest on about 400 consumer loans and had sustained no actual losses as a result. *Id.* at 262–63. Such management failure seems on an entirely different scale than the failure of JPMorgan's risk management in London Whale.

73. 12 U.S.C. § 5365(a) (2012).

stringent” prudential supervision than that applied to “bank holding companies that do not present similar risks to the financial stability of the United States.”⁷⁴ Dodd-Frank requires the Federal Reserve to establish more stringent standards that include: “(i) risk-based capital requirements and leverage limits . . . (ii) liquidity requirements; (iii) overall risk management requirements; (iv) resolution plan and credit exposure report requirements; and (v) concentration limits.”⁷⁵ Further, publicly traded bank holding companies with \$10 billion or more in assets must establish a risk committee responsible for overall firm risk management.⁷⁶ Bank holding companies with \$50 billion or more in assets are subject to an annual stress test conducted by the Federal Reserve.⁷⁷

Also in response to the Financial Crisis, the OCC developed “Guidelines Establishing Heightened Standards” that apply to national banks with \$50 billion or more in assets.⁷⁸ The guidelines were developed to “enhance [the OCC’s] supervision and strengthen the governance and risk management practices of large national banks.”⁷⁹ The OCC’s guidelines direct covered national banks to establish a risk governance framework with features to ensure the independence of the risk management function from the front line (i.e., revenue generating) units.⁸⁰ The guidelines also direct the boards of large national banks to oversee the implementation of effective risk governance and to approve any significant changes in the framework.⁸¹ The OCC indicates that its guidelines are part of similar efforts of banking supervisors around the world.⁸²

While Congress and the banking agencies have clearly shown the desire to hold large banks to a higher standard of risk management, no analogous directive addresses the liability of individual managers. Officers and directors of small community banks are held to the same statutory

74. *Id.* § 5365(a)(1)(A). Dodd-Frank’s system of enhanced supervision has been the subject of strong criticism. For example, U.S. Representative Hensarling has introduced the Financial Choice Act, which would unwind much of the enhanced supervision regime. *See* Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. (2016).

75. 12 U.S.C. § 5365(b)(1)(A). The Federal Reserve may establish an enhanced supervision that relates to contingent capital, resolution plans, public disclosures, and short-term debt limits. *Id.* § 5365(b)(1)(B).

76. *Id.* § 5365(h). The risk committee must include independent directors and at least one risk management expert. *Id.* § 5365(h)(3).

77. *Id.* § 5365(i)(1).

78. 12 C.F.R. § 30, Appendix D (2016).

79. OCC Guidelines Establishing Heightened Standards, 79 Fed. Reg. 54518 (Sept. 11, 2014).

80. 12 C.F.R. § 30, Appendix D.

81. *Id.*

82. In its final rule adopting, the OCC cites the following: FIN. STABILITY BD., THEMATIC REVIEW ON RISK GOVERNANCE PEER REVIEW REPORT (2013); PRINCIPLES FOR AN EFFECTIVE RISK APPETITE FRAMEWORK (2013); BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR EFFECTIVE RISK DATA AGGREGATION AND RISK REPORTING (2013). *See* OCC Guidelines Establishing Heightened Standards, 79 Fed. Reg. at 54518 n.4.

standards for administrative liability as the officers and directors of the largest international banks. Ironically, the reality of too-big-to-fail means, effectively, that only the management of smaller banks can be the target of powerful civil suits brought by the FDIC as receiver. Adding insult to injury, the fact that the directors of smaller institutions are more likely directly involved in management probably means that they are also more likely targets of administrative enforcement actions in which the standard of culpability often requires something closer to intentional or reckless behavior. In addition, the increased scrutiny that comes along with bank failure⁸³ may also lead to more enforcement actions which, again, means that officers and directors of smaller banks are more likely than managers of larger institutions to face administrative charges.

For these reasons, Congress's demand for enhanced supervision of large banks was not matched with a parallel expectation of stricter management liability. This seems worthy of reconsideration. Given the significant negative externalities associated with the operations of large banks, should negligent or grossly negligent behavior by managers go unanswered? As discussed above, in the context of London Whale, current statutory authority for Second Tier civil money penalties and cease-and-desist actions might be available based on negligence. The Fifth Circuit's interpretation of "unsafe or unsound practices" might be a potential road block.⁸⁴ And yet, the Fifth Circuit's narrow interpretation would seem contrary to the goals of prudential regulation and to Congress's intent to create a flexible standard.

As discussed above, the statutory requirements for orders of removal or prohibition are especially onerous. The high level of culpability has been justified given that an individual's "livelihood" is at stake.⁸⁵ This may be a powerful concern in the case of officers and directors of small community banks. However, such concerns seem far less compelling when considering the officers and directors of very large banks. Consider, for example, the individuals serving on JPMorgan's current risk policy committee.⁸⁶ All are retired corporate executive and business owners whose "livelihoods" would hardly be at risk if they were to lose their board positions.⁸⁷ This does not mean that their service as directors is not desirable. The expertise of such

83. A bank failure that results in material loss to the FDIC is subject to an ex post material loss review by the supervising agency's Office of Inspector General. 12 U.S.C. § 1831o(k) (2012).

84. See discussion of the *Gulf Federal* case, *supra* note 72.

85. See *supra* note 61 and accompanying text.

86. *Risk Policy Committee*, JPMORGAN CHASE & CO., <https://www.jpmorganchase.com/corporate/About-JPMC/ab-risk-committee.htm> (last visited Mar. 1, 2017).

87. The members of JPMorgan's risk policy committee are: Linda Bammann (retired bank executive); James S. Crown (president of a family investment company); Timothy P. Flynn (retired KPMG executive); and Michel A. Neal (retired GE executive). See *id.*

individuals could be vital to risk management of a highly complex institution. Yet, if such directors, or other officers and directors in a similar position, were to engage in negligent or grossly negligent behavior, it seems appropriate to consider whether the banking agencies should have the authority to remove them from the board and prohibit their future affiliation with any large bank. When balancing the potential negative externalities resulting from negligent management against the loss to individuals, the public interest should prevail.

Objections to any enhanced administrative enforcement powers include the potential for abuse by regulators and the related chilling effect on a bank's ability to attract and retain qualified board members. These concerns are serious but potentially less serious in the case of large banks. While smaller institutions may suffer at the hand of overly zealous or arbitrary enforcement, large institutions have the financial and political resources to defend such actions. Moreover, administrative enforcement actions are subject to judicial review.⁸⁸ Finally, some objections to enhanced administrative enforcement could be addressed by narrowing the scope of broader forms of liability. This discussion, for example, focuses on enhanced liability for officers and directors of large institutions (those subject to enhanced supervision), not smaller ones. In addition, enhanced liability standards could apply only to bank executive officers, who have direct responsibility for bank management, and not outside directors, whose responsibilities are in the nature of oversight only.

Notwithstanding valid concerns, allowing for administrative sanction based on negligent behavior could provide a powerful incentive for the officers and directors to exercise all due care (i.e., the absence of negligence) in managing these complex organizations. Individuals lacking confidence in their ability to devote due care to their management responsibilities should decline to serve in that capacity.

CONCLUSION

Scholars have argued that existing standards of fiduciary duty do not match the responsibilities of directors of large, systemically important, financial institutions. Big banks are public instrumentalities by nature and the private shareholder value/profit maximization model of governance is an ill-suited guide to the management of their operations. This means that fiduciary duty principles—as currently imagined—do not demand the kind of governance that is appropriate for such firms. Certainly, concepts of fiduciary duty could be reformed—and others have suggested such

88. The respondent in a removal proceeding, for example, may seek judicial review under the Administrative Procedure Act. 12 U.S.C. §§ 1818(e), (f), (h) (2012).

measures. The agencies' administrative enforcement powers, however, should not be overlooked. Existing statutes provide ample authority to the banking agencies to address the most egregious behavior—intentional, reckless, and willful behavior. But existing statutes create obstacles for regulators' pursuit of administrative sanction against board members who have behaved negligently, even if the behavior is grossly negligent. With regard to the officers and directors of large financial institutions, this lack of enforcement power is at odds with Congress's creation of heightened supervision for large banks. Establishing more stringent rules, but then holding management responsible (theoretically) for failure to adhere to such rules only when their behavior is especially egregious, is a system that provides weak incentives for proper management of the largest financial institutions. Strong administrative enforcement authority could better match the need for heightened supervision of large financial institutions with private incentives to ensure that stricter standards are achieved.